Rating Update: San Diego (City of) CA

MOODY'S UPGRADES TO A2 FROM A3 THE RATING ON SAN DIEGO'S GENERAL OBLIGATION BONDS

RATINGS ON LEASE SUPPORTED OBLIGATIONS ALSO UPGRADED

Municipality
CA

Opinion

NEW YORK, Aug 28, 2008 -- Moody's has upgraded to A2 from A3 the rating on the City of San Diego's general obligation bonds. We have also upgraded the ratings on the city's various lease supported obligations listed below. The outlook on all the ratings is stable. The rating upgrade reflects notable, and now confirmed, improvement in the city's financial position - although significant financial pressures remain - and the resolution of the ongoing investigations that had hampered the city's financial reporting and contributed to a general environment of crisis and uncertainty. In the last two years the city has released four Comprehensive Annual Financial Reports (CAFRs), for the fiscal years ending 2003 to 2006, confirming our prior view that the city's financial position had been severely stressed but a manageable challenge. Based on the city's unaudited financial results for 2007, the city appears to have significantly improved its financial position, most notably by more than doubling its general fund reserves. Estimates for the year ending in 2008 and a reasonably balanced budget for 2009 lead us to believe that the city's financial position is stable, although the city's flexibility remains very limited, as anticipated growth in revenues moderates while fixed expenditures continue to claim large portions of the city's budget. In January 2006, the city's governance changed significantly, which provided an opportunity to re-focus financial management and priorities. The city's financial position has benefited from this effort. As elsewhere in the state, the San Diego area economy is affected by the housing downturn, as slightly higher unemployment rates indicate. However, the city's economy remains fundamentally diverse, which should enable it to recover more a quickly than the more concentrated economies elsewhere in the state.

GOVERNANCE CHANGES PROVIDE OPPORTUNITY TO ADDRESS SIGNIFICANT, LONG-TERM FINANCIAL CHALLENGES IN THE GENERAL FUND

In 2005, the voters approved a "Strong Mayor" form of government for a five-year trial period ending December 31, 2010. This significantly shifted power from the city's "legislative" branch to its executive branch. Under the new form of government, the Mayor has veto power over nearly all resolutions and ordinances passed by the City Council except for the Annual Appropriation Ordinance. Council override of the Mayor's veto requires five of eight votes. The first Mayor elected to serve under this system is the former Chief of Police. The Mayor has designed a new organizational structure, including the establishment of the new position of Chief Financial Officer.

Financial challenges facing the new team were significant. In the short run, financial flexibility needed to be enhanced as the cost of numerous investigations was draining already severely depleted reserves. Funding of the city's pension liability was the city's main challenge over the long run. As subsequent CAFRs confirmed, between 2004 and 2006 the city's reserve position was severely depleted but financial operations were essentially stable as general fund revenues approximated expenditures. The general fund balance hovered at approximately $61 million. However as the budget grew, these balances decreased from 8.0% of revenues to 6.8%. At the end of fiscal 2006, the city's general fund cash balance stood at just $23.3 million. This is exceedingly small for a city of more than a million and a general fund budget one of more than one billion dollars, and it affords very little flexibility or protection against unforeseen events. The city's financial position improved significantly in 2007 as the generally favorable revenue environment combined with significant expenditure reduction to yield an estimated unaudited general fund surplus of approximately $70 million. The resulting general fund balance of $130 million represents 12.3% of revenues, which is significantly higher than the end of 2006 but remains below the median of 21.7% for California cities with populations over 300,000. On the revenue side in 2007, property and transient occupancy taxes continued to grow and outpaced their respective budgeted amounts, while sales tax lagged behind expectations. Vacant positions contributed to significant savings in labor costs, which combined with reductions in supplies and services to contribute to the operating surplus.

While the city's financial performance was favorable in 2007, estimates for 2008 and the budget for 2009 indicate no significant improvement over 2007. A small general fund deficit is estimated for 2008, resulting primarily from unexpected costs attributed to fires and a landslide. As the softness in the economy takes its toll on revenues, budgetary cutbacks have become more difficult, as many of the less painful cuts were made in fiscal 2007. Cuts in public safety have been minimal and further cuts are not likely to be significant. The city's commitment to aggressively funding its pension and other post-employment liabilities is also limiting the city's budget flexibility. The city is fully funding its Annual Required Contribution (ARC) for the Unfunded Accrued Actuarial Liability (UAAL) in its pension system based on a 20 year amortization schedule, rather than the 30 year schedule most municipalities are using. And it is paying more than the "pay-as-you-go" amounts for its Other Post Employment Benefits (OPEB) ARC. Most municipalities remain on a pay-as-you-go funding schedule for their OPEBs. In 2009, the general fund portion of these two expenditures is estimated at $192 million or nearly 17% of general fund expenditures. While this ambitious schedule places the city in a favorable position with regard to these long-term liabilities, it leaves the general fund with limited resources for additional city services and/or contingencies in the near term. As of June 30, 2007, the pension system's UAAL of $1.18 billion was 78.9% funded. The OPEB liability was slightly over $1 billion. In 2008 the city established an OPEB trust with CAPLERS and made a $30 million contribution. In 2009 the budgeted contribution is $50 million with $26 million for pay-as-you-go and $24 million for the actuarial liability. Only with significant improvement in its revenues, which are dependant on the economy and the real estate market along with other developments, will the city be able to significantly improve its financial position or increase services.

While we believe that the city's finances will remained strained for some time to come, the city's comprehensive reserve policy affords some additional bond holder security, as it provides some assurance of the maintenance of a minimum level of reserves. The city's goal is to increase its general fund reserves to 8% by 2012 from its June 30, 2008 level of 6.0% (or $66 million). Based on projected results for fiscal year 2008, an additional $3.7 million contribution is budgeted in 2009 to meet the 6.5% policy target.

.

CITY'S ECONOMY IS WEAKER BUT REMAINS DIVERSE

The city's ratings benefit from the size and diversity of its local economy, although current indicators are not as favorable as in the past. The June 2008 unemployment rate reached 5.9%, up from 4.6% of June 2007, but remains below the state level of 7.0%. However, we note that the 2008 unemployment rate is based on total employment growth of 1.2% from the prior year. Economic strain is also evident in the citywide Assessed Value (AV), which is estimated to increase by just 4.5% following a 5 year period through 2008 with an average annual growth of nearly 10%. Total AV is expected to reach approximately $189 billion in 2009 for an estimated full value per capita of $150,000 or significantly above the statewide median. The low AV growth in 2009 is primarily the result of falling residential housing values, which, by some measures, have decreased by more than 15% during the last 12 months. As dramatic as this decline is, it is less than the countywide decline of nearly 19% or the statewide decline of more than 21%, underscoring the resilience of the San Diego area economy. Taxable sales are also showing the weakness in the economy. In 2007, taxable transactions in the city decreased by 1.7% from 2006. This trend is continuing in 2008. However, transient occupancy taxes, which represent about 8% of general fund revenues, are continuing to grow, which reflects the strength of the tourism sector of the economy.

Outlook

The outlook on the ratings is stable. Moody's expects the city to continue to operate under generally tight but stable financial conditions. Given the city's modestly growing but limited reserves, significant deterioration of reserves can put downward pressure on bond holder security. By adhering to its reserve policy, the city can avert such credit deterioration. While the current economic conditions are weakening revenues, in the long term the city's economy will benefit from its size and diversity.

GENERAL OBLIGATION BONDS:

Upgraded to A2 from A3:

GENERAL FUND OBLIGATIONS, CERTIFICATES OF PARTICIPATION AND LEASE REVENUE BONDS

Upgraded to Baa1 from Baa2:

2003 - 1993 Balboa Park/Mission Bay Park Refunding

2003 - 1993 City/MTDB Lease Revenue Refunding Bonds

2002B - Fire and Life Safety Facilities Project

1998A - Convention Center Expansion

1996 A and B - Balboa Park/Mission Bay Park Capital Improvements and Refunding

1994 - City/MTDB Lease Revenue Refunding Bonds

Upgraded to Baa2 from Baa3:

1996A (Taxable) - Jack Murphy Stadium

Analysts

Kevork Khrimian
Analyst
Public Finance Group
Moody's Investors Service

Dari Barzel
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653